DEVELOPMENTS IN CORPORATE GOVERNANCE

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Introduction

For many observers the burgeoning corporate governance debate seems to be led as much by fashion as by rational progression. And so whilst official consultation is currently centering around the Higgs and Smith reports, it is the connected but separate debate surrounding excessive executive remuneration which has most recently captured headlines. Indeed, despite over one and a half decades of regular corporate governance reviews, in some ways, the subject area seems less defined rather than clearer. At the same time, a significant number of lawyers, consultants, accountants and bankers are increasingly having to be deployed (and paid) to advise on levels of compliance in an area which has seen constantly shifting goal-posts.

My own experience comes from my practice as a corporate solicitor. But also, as a member of the House of Commons Trade and Industry Select Committee, I recently had the opportunity of participating in the Committee's enquiry into the Government's White Paper on Company Law Reform and corporate governance. To the extent that this enquiry presented me with the opportunity to hear first hand from many of the interested parties (dare I say stakeholders), including Mr Higgs, I shall be referring to evidence given to the Committee in this talk.

Is corporate governance addressing the right issues?

Many people, particularly within the business community, increasingly view corporate governance as some kind of monster growing out of control. Whether or not this represents a fair description, there are most certainly a wide variety of different agendas which either have or may have significant implications for companies. It would therefore certainly be a mistake for anyone to consider that just because an issue of corporate governance is not contained in the Combined Code of the United Kingdom Listing Authority, as now stated or as it may be post the Higgs report, it was not relevant.

So what was the Government's justification for commissioning the Higgs and Smith reports? Looking at and having heard various Government statements on this, the issue which keeps coming up is the fraud discovered in Enron. However, in practice, there is little to be found in either the Smith or Higgs reports that would deal with an Enron situation. Clearly, the main thrust of Government policy to date has been to review corporate governance in the context of directors' and auditors' responsibilities. But is this the right balance - directors and auditors being only part of the story. Should we be spending more time looking at the relationship that institutional investors have with the companies in which they invest as active or non-active shareholders and also individual shareholders' relationships with their companies. Or should we be concentrating more on the confidence that the institutions inspire in the market place as well as reviewing the way the market place itself works. Corporate governance of course covers all of these issues.

What is the purpose of corporate governance?

As this moving feast continues apace, I believe that not only are we in some danger of losing the plot but that we also do now need to stand back and reconsider what we actually want to see as the end result from corporate governance. There must be a purpose and it is that purpose which I shall now consider.

In the broadest sense, the purpose of corporate governance must be to produce effective administration of companies and transparency for shareholders. But we need to appreciate that for some it represents other things, such as a mechanism for improving environmental and social justice. Accordingly, whichever way you look at it, the ultimate purpose of corporate governance will depend on your politics and the best that will ever be achieved is a consensus that is generally acceptable to the various interested parties. However, I shall be arguing that the viability of the chosen corporate governance procedures will be directly dependent upon reaching such a broad consensus.

Having said that, there are general internationally held aims that have, in recent years, provided pointers as to what effective corporate governance should involve:

- it should help companies raise capital by improving investor confidence via transparency of performance and ownership as well as by the monitoring of management;

- it should help managers increase their company performance and reduce the opportunities for complacency and fraud; and

- it should help companies comply with the laws and moral expectations of the societies in which they operate.

But what currently is fuelling the Government's belief that changes to the existing levels of corporate governance now need to be delivered? The Government consistently refers to Enron, but Britain has not seen Enron sized instances of fraud since the inception of the Combined Code. Additionally, problems of weak performance are normally just as much to do with the bad running of the company concerned, rather than being an issue of corporate governance. When the Committee took evidence on this point, it was a representative of the Institute of Directors who gave Marconi as an example. Marconi probably had very good corporate governance mechanisms and systems but what it did not have was effective executive management or people [non-executive directors] who were asking the right questions at the appropriate time. Accordingly, whilst corporate governance has a role in minimising and uncovering mis-management as well as reviewing it after it has happened, there is still no guarantee that it will provide an effective mechanism to spot what is going wrong as it is going wrong. Indeed, when it comes to out and out fraud ie the type of cases that take up six months of Old Bailey court time, this will always primarily be an issue for the DTI, FSA or the OFT, rather than a once a month meeting of independent non-executives.

So again, what is the actual driving force here? My view is that it is essentially down to international pressures and the advancement of globalisation. This manifests itself in two key ways:

Firstly, companies have proved themselves as an effective way of organising progress whilst, internationally, governments have been retreating from involvement in companies. We see this from the initial privatisation of state companies in the UK to the wholesale mindset changes happening in Eastern Europe and now even in China. However, with these changes there has at the same time been a growing unease that, left unaddressed, companies could transcend the values and political power of their own countries or indeed of other countries in which they operate.

Secondly, capital is now available globally rather than just in one's own country. In 2000, institutional investors held some $24 trillion in financial assets in the world's five top markets and over 75% of these assets were held solely by US and UK investors. It is also worth pointing out that two thirds of US foreign investment at that time was held by only 25 US pension funds. If we were to take a cynical view of this, it could be said that what is acceptable in terms of the content and speed of corporate governance changes is effectively being driven by only two governments, namely the US and the UK, consulting with a restricted number of large institutional investors as well as a restricted number of the largest multi-national companies. This is not to say that there are not thousands of interested persons and companies who will wish to comment on proposed changes to corporate governance rules, but it does show where the power lies. It may also show why many smaller and medium capitalised companies, which include most UK listed companies, feel increasingly detached from the whole process. It could also explain why there is a corporate governance leapfrogging effect going on between the US and the UK. Such as with the Sarbanes-Oxley Act in the US pushing corporate governance provisions attaching to auditors further than that which existed in the UK after the Hampel Code of 1998, at least until the Smith proposals allow us to catch up with the US.

Pace of change

So there is a global context which is driving the corporate governance ratchet. However, from the perspective of most British listed companies, to reach the vital consensus of acceptability, there will need to be something more relevant to their own operations than simply an acknowledgement that they are being carried along on an international wave by a Government that is at pains to show that it is being proactive. I am not arguing here that there is not much that is worthy in the Higgs report nor that effective corporate governance would ever be a discipline that could stand still with no need for review. However, in most areas of corporate regulation, it is the case that change tends to be evolutionary with individual proposals being carefully reviewed on an ongoing basis, whether in relation to a proposed change to company law, the rules of the UK Listing Authority or the rules of the Takeover Code. Even in relation to the Company Law Review, which does propose a wholesale redrafting of the Companies Act, changes have only been proposed following years of intensive consultations.

However, with corporate governance it seems that the standard routine is for companies and Government to all but ignore the subject and then, every five years or so, for everyone to have a huge level of soul searching and confrontation. This is normally in keeping with a downturn in the economy sparking off the uncovering of corporate excesses which were perpetrated during the previous boom times. Reactive measures are often the worst ones – and it is one of my concerns that if we are to have an all embracing review of corporate governance we should not be sidelined by single issues that grab the press's attention at any one time, such as excessive directors remuneration, at the expense of missing the overall picture and keeping in mind the overall purpose of what we are doing.

There is certainly inadequate time today for a total review of corporate governance. However, with the aim of exploring where corporate governance should be heading, I shall base my thoughts around two key themes, namely the concept of the unitary board and also shareholder participation.

The unitary board

The unitary board is an important concept in business practice in this country and the US as it essentially forms the basis of most aspects of corporate governance as applied to directors. Over the last decade, there have been many comparative studies between the UK unitary board system and the systems used in other countries and I think it is worth highlighting a few of the cultural variations.

In Japan there are unitary boards run by strong chairman and few non-executives are to be found, other than in the largest companies. In practice, Japanese companies are run by a small core of executive directors who decide everything (including board nominees) and their concept of corporate governance is somewhat removed from that advocated by Mr Higgs. However, the investment and strategy decisions taken by Japanese companies tend to be more long term than is generally found in the UK. This somewhat undermines the idea that ramping boards with independent non-executives is necessarily going to improve long term strategic thinking and investment – both of which are of course meant to be priority issues for this Government. We should also keep in mind that a review of the mechanisms within companies to increase productivity was originally a key objective that the Government gave to Mr Higgs for his review although, in the event, this seems to have been mostly forgotten about. Whilst some would refer to the effect of Japanese values of social cohesion and acceptability as factors in governance matters, particularly in Japan, long termism has been more connected to the frequency of interlocking shareholdings within particular sectors rather than corporate governance. This in turn has reduced the incidence of takeovers based on short term performance. Additionally, there has historically been a culture in Japan of long term bank relationships and a reliance on debt rather than equity to finance corporate activity.

Again, in Germany, there has likewise traditionally been an emphasis on long termism which has led to there being little bid activity, large inter-company shareholdings and strong links with banks and a reliance on loans rather than equity financing. Germany does have a system of two tier boards, with a supervisory board technically watching over management. But such supervisory boards often rarely meet and are themselves frequently dominated by the same company bank representatives who have such close relationships with the executive directors.

Historically, in Germany and Japan, shareholders have had little status and companies are run for the benefit of the company rather than shareholders. In both countries, change towards better corporate governance is basically limited to the largest companies and more particularly to those that require equity funding where it is instigated on the back of institutional investor pressures which, for the most part, means US capital.

It is worth reviewing other systems if only to appreciate that effective corporate governance, as we understand it, does not necessarily lead to more efficiently led companies or indeed a culture of long term creation of shareholder value. In the UK, attempts to encourage long termism are centering on the role of the Operating and Financial Review, rather than companies' relationships with banks or moving to a two tier board structure. Various organisations, such as the Centre for Tomorrow's Company, have looked at this problem. They highlight the potential for the OFR and believe that it is vital to require companies to state their purpose and values in their OFR in order that shareholders and other stakeholders can start to form a clear view as to the company's progress and integrity in living up to its own stated values. Noble intentions certainly, but will this approach work?

For the largest companies, it may help investors and other interested parties – but I doubt whether there will be much benefit when it comes to small and medium capitalised companies. I remember, some five years ago, when the Pensions Act 1995 came into force which required pension funds to draw up a Statement of Investment Principles (SIP) outlining their investment policies. These regulations also required trustees to expand the issues covered in SIPs and state "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments." In order to comply with these provisions, institutional investors started to place pressure on companies, and particularly property companies, to include environmental reports in their annual report. One of my firm's largest property clients conducted a full, thoughtful and costly review of their environmental policies. However, shortly thereafter a small listed property company client requested help with the production of their own environmental report and started the ball rolling by providing me with copies of a few of their larger competitors' reports that they basically wanted to crib. I make this observation based on the realities of life for the smaller listed company, rather than what may be best in an ideal world. But, essentially, for the smaller company, it had become a box ticking exercise rather than any kind of attempt to portray a long term strategy. However, to be fair, in their submission to the Committee, the Centre for Tomorrow's Company did say that compulsory reporting only becomes useful once indicators have matured and industry sectors have had time to develop best practice and comparability.

Threats to the unitary board

One of the major surprises of the Committee's enquiry for me, was the almost universal acceptance of the unitary board by participants in the enquiry, albeit with reservations from some organisations such as the TUC. However, as evidence taking proceeded, the arguments became somewhat more complicated.

The traditional position is that a company's directors main priority is to maximise value for the company's shareholders. Although, following the line proposed in the Company Law White Paper, this concept is to be slightly amended to adopt the theory of "enlightened shareholder value", which basically means that other relationships such as those between the company and employees, customers and local residents are important enough to be taken into account when directors judge how to carry out their duties.

On the other side of the debate is the pluralist approach which believes in forcing directors to consider interests of stakeholders in their own right, so that shareholders are relegated to the position of only one of a number of a number of interested parties. The Company Law Review rejected the pluralist approach on the basis that it confuses directors' duties and would encourage litigation. Historically, supporters of the traditional approach would also have been the strongest supporters of unitary boards and the pluralist would have preferred supervisory boards which they felt would be the most appropriate forum in which to include stakeholders (although it is highly debatable whether this happens in practice in countries which have supervisory boards).

However, now that the Company Law White Paper and the Higgs report have both shown clear support for the basic concept of the unitary board, the pluralist argument has been adapting itself to accommodate this structure. Accordingly, there will remain threats to the concept of the unitary board and I shall provide four examples of this.

The TUC

Firstly, whilst the TUC does now accept unitary boards they have adapted their position by stating a wish for union employee representation on the nomination committee and the remuneration committee of companies. Clearly, this could be seen to represent a threat to the traditional concept of the unitary board – albeit in a new guise. However, interestingly, the TUC are no longer expressing a wish to become board members per se and the Committee questioned the TUC further on this area. It was noted, for instance, that the TUC had been keen to support the Myners report which recommended active institutional investor ownership. However, the TUC also noted having some 700 union nominated trustees on their database, serving on pension schemes with assets of over £300 billion, who they admitted were generally not very active at all. Furthermore, a company in my own constituency recently went into receivership leaving an underfunded pension scheme which had two union trustees who were naturally very concerned as to their positions. Perhaps, the TUCs experience with pension fund representation has had something to do with guiding them away from requiring two tier boards or indeed board appointments. Of course, with increased power and responsibility comes increased potential liability – a topic I shall return to.

Corporate and social responsibility

A second threat to the traditional concept of the unitary board arises from what is loosely called the corporate and social responsibility lobby. Organisations such as the Corporate Responsibility Coalition (CORE), representing some 25 organisations, including Amnesty International UK and Friends of the Earth, are also switching their emphasis from stakeholder representation on supervisory boards to calling for unitary boards to conduct social and environmental reporting. This would be mandatory for all companies with a turnover of £5 million or more and would also involve stakeholder rights to participate in the reporting process and a legal duty being placed on the directors to uphold this right. In brief, CORE bases its case on its belief that voluntarism has failed and that regulation and outside controls over companies are therefore necessary. From my point of view, I have great concerns with the one size fits all approach that the CORE agenda implies. Stakeholders will be different in different sectors as will company interests and I do think that it is a somewhat more sophisticated view to believe that sectors should be encouraged to express and develop their own relationships with stakeholders rather than be forced down the one size fits all route. We do come back to cultural change here, but also the need to appreciate the real costs of producing such things as environmental reports at £30,000 to £100,000 a shot.

Additionally, this whole agenda does seem to be too much aimed in one direction, that is for companies to bear the costs of reform. The Government has instigated various environmental regulations, such as the aggregates tax and the climate change levy – but why can it not provide more incentives of the carrot variety, such as tax benefits for those that display enlightened environmental credentials. This approach would, I am certain, encourage a much faster change of culture within the business community and an increased willingness to engage with stakeholders.

However, business should be aware that the social and environmental agenda is unlikely to disappear and indeed is growing. In 1995, a MORI poll showed that MPs considered financial performance twice as important as environmental performance, when making a judgment about a company. But by 2001, MORI showed that environmental performance was considered more important by MPs than financial performance. Accordingly, business would be unwise to ignore this agenda and early engagement in the issues concerned should be recommended. Too often in the past, as is to some extent currently the case with Higgs, a late response by business looks reactive and therefore negative. Having said that, I do recognise that many larger companies are aware of this agenda and have been taking action but, again, little in the way of cultural change has yet filtered down to smaller companies.

Does Higgs threaten the unitary board?

A further threat to the traditional concept of the unitary board could arise from the Higgs proposals themselves. On the face of it, technically speaking, the Combined Code with its comply or explain regime means that companies can deviate from what is deemed to be best practice, for example if they feel that their company is too small to justify the costs involved in compliance. Indeed, a recent report of Grant Thornton showed that over half of Britain’s top 350 companies failed to comply fully with the existing (pre-Higgs) Combined Code of corporate governance. However, if we are to have a meaningful code of best practice, then companies will have to buy into the existing code, let alone Higgs. If this is not the case, as Don Cruickshank the recently departed chairman of the London Stock Exchange explained, it is likely that we will see an increase of meaningless box ticking, which is already prevalent amongst smaller companies. On the other hand, institutional investor representatives, such as PIRC, themselves conduct their own box ticking compliance exercise. Accordingly, without consensus, the whole system could easily break down and become irrelevant.

At the same time, unacceptable regulation could well lead to less IPOs and an increase of fully listed companies re-listing on AIM, where the Combined Code is not applicable. That is, of course, if directors don’t get put off working for listed companies altogether, and increasingly decide to join venture capitalist management buy-in teams in the unlisted sector.

There have, of course, been many criticisms of the Higgs proposals from a variety of people and I shall not restate them all here, other than to take a few examples to consider their impact on the unitary board. Derek Higgs, it has to be said, has proclaimed his support for the unitary board structure and believes that his proposals will add, rather than detract, from their operation – but is this the case?

Independent non-executive directors

To my mind, the crux of the issue here lies with the Higgs reliance on the importance of the independent non-executive director. This raises various issues.

Firstly, in relation to who can be deemed independent – which would exclude chairmen (even though the chairman is supposed to be independent immediately prior to his appointment) and anyone else who has been on the board for 10 years. That is, of course, keeping in mind that Higgs additionally only recommends allowing two or three terms of three years for non-executive directors.

Secondly, in relation to the Higgs recommendation that independent non-executive directors should constitute a majority of the board. So, for example, a board with four executive directors would require five independent non-executives plus a chairman and plus any other non-executives that the company may wish to retain. Accordingly, the smaller company who wishes to comply with Higgs, may be tempted to reduce the number of its executive directors to two. This is the standard number of executives in the United States model of the unitary board, and such a reduction would both save costs and avoid a cluttered board. However, many people's evidence to the Committee's enquiry praised the UK practice of including more than just the CEO and the FD on the board. Mr Roger Davies of PWC, representing the Institute of Chartered Accountants, made it clear that in his view the UK unitary board structure had the great advantage of regular meetings with the non-executives present with the management. This means that non-executives have got a better chance of knowing what is going on in the company than is often found in the more council-like boards which meet in the United States. Mr Davies also advised being very careful of not ending up with a two tier board structure by creeping changes. Indeed, what seems so strange about all this is that in the US they are increasingly looking to the current UK model, blaming the inability of their non-executive dominated boards to know what is going on in their companies in the absence of wider executive input on their boards.

But thirdly, this issue runs deeper than the main board because the Higgs and Smith reviews propose that the remuneration and audit committees should have three members, all of whom should be independent non-executives (which would exclude the chairman). Within these structures clearly lie the possible grounds for two tier boards appearing by stealth and by splits and divergences between the board and its committees and thus exists a further threat to the concept of the unitary board. This issue has been behind many objections to the Higgs report from company chairmen. They frequently see their role as cutting across the various committees and ironing out dissent where necessary. Many chairman have therefore rejected the way in which the Higgs proposals threaten to inhibit their role and provide the potential for them to be undermined. For instance, through the senior non-executive chairing the nominations committee or holding private talks with institutional shareholders. Of course, an active board will include challenging ideas and strategies, but an atmosphere of distrust and a breakdown of dialogue would be seriously detrimental. This was a fear raised by the IMA, representing institutions, in its evidence to the Committee. They acknowledged that Higgs proposed that the board's role is to be "collectively responsible for promoting the success of the company by directing and supervising the company's affairs" – but they also stated that this was not enough on its own as corporate failures can often be attributed to boards over delegating the monitoring of risks and performance.

The challenges to the unitary board concept in this regard, not only come from the Higgs report. Indeed, in a recent debate in the Commons, called by the Treasury Select Committee, I argued against their recommendation that audit committees should be responsible for selecting the firm of auditors. On this point, I supported the Smith recommendation that the audit committee should recommend the auditor to the main board. A small distinction perhaps, but another example of how collective decisions under a unitary board are increasingly coming under threat.

Executive and non-executive directors

My final example of potential threats to the unitary board relates to the distinction between executive and non-executive directors. English law makes no distinction between executive and non-executive directors and indeed to do so would in itself undermine the unitary board concept. However, the role of non-executives and executives is becoming increasingly distinct in practice and, following the Higgs proposals, the new responsibilities to be attached to non-executive directors could well lead to increased liabilities for them. Liability, not only in terms of what they are expected to carry out independently of executive directors but, possibly, also in terms of the time that they may be expected to spend on their duties to avoid claims of negligence. And let us remember here that 15 former directors of Equitable Life are currently being sued for more than £3 billion with insurers who are saying that their directors' and officers' insurance does not apply.

I personally remain unconvinced of the wisdom of companies having purely independent non-executive committees. Whilst committees certainly have a role in ensuring effective and transparent communication to shareholders, there seems to be little evidence that as committees have become more independent they have become more effective at penalising non effective managers. Executive pay has, if anything, been significantly enhanced rather than curtailed since the foundation of remuneration committees. These committees normally hire one of a small number of specialist consultants to come up with recommendations for pay. Those consultants are likely to base their views on the upper quartile of bands of international rates which are formed around their own prior recommendations to other companies. This has arguably ultimately had the effect of ratcheting up the amounts paid to directors rather than controlling pay. In this regard, I also do not support the idea of restricting termination payments by statute – which would be a gift mainly for my lawyer colleagues who would be left to argue contract interpretations in the courts. As one fund manager recently put it: "Take Vodafone. Chris Gent got stick over his pay and performance has fallen. But compared with other telecoms companies Vodafone has done well. It was complicated enough to understand how Vodafone judges this. Could you write a law to cover all contingencies?" Ultimately, I believe that this issue should be a matter for shareholders and this I shall return to.

But, with more responsibility, longer hours and more potential liability – why should people wish to serve as non-executive directors? The Higgs report not only recommends appointing non-executives from a broader background, but also realises that there will be a need to have more non-executives in order to fill the jobs which Mr Higgs is creating. However, as I have explained, if we get this wrong we could end up with a situation of having less applicants going for more jobs. In practice, I think that this will be accommodated and that more non-executive directors will come forward in the medium term, but at a cost. Average fees to non-executive directors rose by 10% last year to £24,000 and in the FTSE 100 the typical fee is £50,000 with up to £15,000 extra for chairing a committee. In one case a non-executive chairman received fees of £117,000. These costs are likely to rise significantly following the Higgs reforms as NEDs responsibilities and potential liabilities grow. Companies will also have to meet much higher directors and officers insurance premium costs, even though the scope of such insurance is being significantly narrowed by insurance companies. Higgs addresses this by suggesting that the provisions in the Companies Act allowing companies to indemnify their directors should be expanded. But this would be an additional cost to the company and possibly, in circumstances such as with Equitable Life, a ruinous one.

Accordingly, I do believe that it is quite arguable that not only do the Higgs proposals represent a potential threat to the principle of the unitary board but that in certain ways the outcome of increased corporate governance along Higgs lines could have the opposite effect that most people would expect. Namely, diverging roles for executive and non-executive directors, an increased potential for board conflict and also greater remuneration and fee packages for both executive and non-executive directors.

Could it actually be the case that the Government have placed too much emphasis towards reviewing the role of auditors and directors whilst underplaying the corporate governance role of the company's owners – its shareholders.

Institutional shareholders

On the final day for consultation on the Higgs report in April, 15 senior managers from top City investment funds wrote a letter to the Financial Times supporting the new Code's implementation without delay. I think that the keenness of the managers to move things forward, as well as their very limited engagement in debating the proposals over recent months, deserves further attention. Whilst it could be that these managers feel that delay could be de-stabilising to the markets, would it be overly cynical of me to consider that these managers may also have felt that added delay could have encouraged people to review the asset managers' own role in corporate governance?

The Higgs report does of course address the role of institutional shareholders and recommends that they question boards on corporate governance matters. Mr Higgs notes the Myners review of April 2001, which suggested legislation to oblige institutions to promote their beneficiaries' interests. He also noted the November 2002 Institutional Shareholders Committee, Statement Of Principles On Shareholder Activism. Effectively coming down on the side of the institutions, the Higgs report proposes that the ISC Code be endorsed in the Combined Code and adds that institutional investors should attend AGMs where practicable. Indeed, considering the massive advance of box ticking compliance procedures used by investor representatives, such as PIRC, it is a welcome development that the Higgs report proposes that, in evaluation of corporate governance arrangements, "institutional investors should give due weight to all relevant factors drawn to their attention." Hopefully, this will reduce the wall of indifference that many directors have come up against when trying to explain their deviations from the Code to the institutions.

Clearly, to some extent, the ISC Code represents an attempt to ward off Government legislation for "informed intervention" as suggested by the Myners report. However, this is an area of corporate governance that has only been very lightly reviewed in comparison to directors' duties, not only in terms of the activism of institutions but also in relation to their own investment policies and the mechanics as well as the structure of their own funds. For instance, index tracking funds, which now constitute more than 20% of all equity funds under management, are often unable to sell shares as they have to keep their portfolios balanced on the index.

United States developments

I think also that we need to note what is going on in the United States. In May 2003, ten of the top US banks settled dozens of charges brought by the New York Attorney General at a cost of some $1.4 billion, and this could only be the precursor to hosts of private law suits arising out of the dot.com era. Whether or not fraud is proved in these cases, there are significant corporate governance issues to be dealt with here. Issues such as Chinese Walls between brokers and analysts, whether bankers should have a say in setting analysts' salaries and bonuses and whether banking fees should, effectively, be capable of paying for reports that have sometimes been little more than selling documents. There are questions surrounding banks acting on IPOs whilst secretly paying for “independent” research. In addition, a number of US individual bankers are now facing criminal charges.

In the meantime, the New York Stock Exchange has been investigating various trading activities on its floor, such as “front running” where individuals trade shares on what could be described as inside information, before retail investors get a look in. US brokers are being accused of accepting inflated trading commissions from customers in exchange for participation in placings of stock after IPOs, whilst the SEC is investigating whether certain brokers have been recommending inappropriate share classes of mutual funds for the purchase by their clients and whether other banks helped companies, such as Enron, conceal their true levels of debt. There is now even a new row brewing where a group of senators are hoping to stop banks structuring their SEC settlements in such a way as to maximise the amount of penalty payments that are capable of tax deduction.

So how does this compare with what is going on in the UK? In April 2003 the FSA did indeed fine a bank £900,000 for manipulating share prices and there is talk of pending insider trading actions. But, frankly, the British authorities have failed to take the policy decision to investigate the activities of the institutions in the way that is currently being carried out in the United States. However, with US banks having dominated London equity markets for many years and, with US commission structures and placing mechanisms having been adopted in this country years ago, all of this begs the question to what extent, if at all, have dubious market practices been carried out in this country?

Clearly a key aspect of corporate governance is creating a fair playing field which gives investors comfort in the market place for the company’s securities as much as what is going on within the company itself.

The threat to markets and shareholder rights

However, whether or not institutions have been involved in dubious practices, there are other significant areas of growing concern. For instance, many commentators are now suggesting that banks in the United States are likely to withdraw from the retail broking business and give up selling shares to individuals, preferring to concentrate on a few highly paid brokers acting for sophisticated institutions and carrying out proprietary trading on the bank’s own account. Mr Higgs noted that individual share ownership has fallen from over 50% of the market in the 1960s to less than one-fifth today, and institutions now hold more than half of the equity capital in UK listed companies.

At the same time, small shareholders are being squeezed out of attractive new issues by not being allowed on placing lists and increasingly are being treated as second class citizens due to advances in technology. For instance, the introduction of CREST has meant that trading shares through a broker nominee presents a cheaper option than for a person to hold those shares in their own name. For most small shareholders, the benefits of a faster settlement process are negligible compared to their loss of voting rights and receipt of shareholder information, that is the result of using a CREST nominee. Participation in the markets through institutions is therefore increasingly becoming the norm. But putting your money into tracker funds has hardly been a recipe for enrichment over recent years and, indeed, many institutions have now sold or are threatening to sell their entire equity positions.

All of this leads me to consider that we now need a much wider debate than we have had in the past on the question of corporate governance and shareholder rights. For instance, how best can an institution’s investors call those institutions to account for failing to vote the shares which they are managing on behalf of the individuals, or for slavishly following indexes or alternatively churning their portfolios. And if it is the case that the Higgs proposals are to lead to institutions having easier access to boards and company information, how can small shareholders be assured that they will not suffer from an inequality of information?

Revitalising share ownership

I think it is certainly worth considering the Company Law Review suggestion that institutions should release to the market the times at which their analysts visit companies. When companies raise money, should they be forced to offer a minimum percentage of the offer shares to the public, in order to avoid suggestions of cronyism and unfair commissions? Should we insist that voting and information rights are provided to small shareholders holding their shares in nominee CREST accounts or in PEPs and ISAs? and perhaps we should revisit the question of the frequency and format of shareholder meetings and such related issues as the ability to see how members voted. If there was the ability for people to register abstentions, this would enable people to check whether institutional investors had considered the alternatives rather than simply ignoring the issue or not showing up. There is no type of regulation which will in itself be able to assess appropriate directors' remuneration – but shareholders will have views on this and I see no reason why companies should not be encouraged to put directors' contracts to the vote at AGMs or to have to explain why it was not practical for them to do so.

The creation of a shareholding democracy so purposely pursued, through the privatisation of the state controlled industries in the '80s, seems if anything to have gone into reverse. Whilst I do admit that the current Government have not made it a policy objective to widen share ownership, they have indicated a desire to attract private money towards smaller listed companies. If they seriously believe in this objective, they would do well to listen to the views of organisations such as the Quoted Companies Alliance, which represents more than 300 companies outside the FTSE 350 and specifically in relation to the significant problems that smaller companies are facing in being able to attract money from institutional investors. On the other hand, apart from the problems that smaller companies face in compliance with corporate governance proposals, monitoring their compliance represents a significant and growing cost to the institutions. Accordingly, as the amount of corporate governance increases, it may be the case that the institutions will increasingly automatically exclude smaller companies who are not worth their while monitoring. Many small companies would argue, with some justification, that this is already happening.

In summary, I think that we need to be wary of the view that improving corporate governance, as it applies to shareholders, is only or mainly a question of what institutional investors should be monitoring through active member involvement in companies. This is because the small retail shareholder, who increasingly in recent years has decided not to invest on his or her own account, will ultimately be just as concerned, firstly, with their rights vis a vis an institutional investor who is investing in the market on their behalf and, secondly, in the probity of the market place itself. On this basis, I would suggest that we need a fresh approach here and the best place to start would be to look at the bottom of the investment chain and consider what really is of concern to the individual with some savings to invest. Such a review could also usefully consider mechanisms for increased and broader individual share ownership – but that is a discussion for another day.

Commentary on 'Developments in Corporate Governance', Jonathan Djanogly

by

Elaine Sternberg

It is particularly sad when politicians who claim to support free markets nevertheless condone government regulation. Jonathan Djanogly begins his presentation well, by pointing out that government responses to recent corporate scandals have been misguided and disproportionate, and are likely to prove both expensive and counterproductive. He also correctly indicates that the public discussion of corporate governance is sadly muddled, and that diverse problems are wrongly associated with corporate governance. Unfortunately, Djanogly does not adequately clarify what corporate governance is. As a result, he misinterprets the role of long-termism and the unitary board. And significantly, although he advocates a wider debate on shareholder rights, Djanogly also underestimates the value of shareholders' experimenting with corporate governance mechanisms in a free and competitive marketplace.

The Meaning of Corporate Governance

Properly understood, corporate governance refers to

> the means for keeping corporate actions, agents and assets directed at the corporate objectives established by the corporation's shareholders.[i]

Accordingly, corporate governance should be the responsibility of the shareholders; it is up to them to monitor and protect their own interests. The degree and sort of accountability wanted, and the mechanisms most suited for achieving it, will appropriately reflect each corporation's particular objectives, history, size, activity, jurisdiction and shareholder composition.

Seeking government action to improve corporate governance is triply misguided. It wrongly supposes that any defects in corporate governance have been caused by a lack of sufficient regulation. It erroneously presumes that government regulation can make things better. And it offers support to the mistaken view that corporate governance is a legitimate field for government intervention.

In fact, no government action is needed to criminalise the activities that led to the recent corporate scandals. Fraud[ii] and false accounting are already illegal, and government fiat cannot eradicate dishonesty or mismanagement, ignorance or risk. Regulation can also not eliminate the conflicts of interest, asymmetry of information, and inadequate monitoring that constitute the major sources of defective corporate governance.

Typically, regulation is part of the problem, not the solution. All regulation is inflexible, and imposes substantial costs, in terms of both funds and freedoms: even disclosure is not costless. All regulations have consequences that are unintended, damaging and difficult to correct; laws made in response to perceived crises and hard cases are notoriously defective. Moreover, regulation is often self-defeating. In formalising and clarifying previously unwritten guidelines, regulation typically lowers standards; compliance no longer requires a margin of safety, but can be obtained by satisfying the letter of the law. Regulation also typically constitutes an inherent moral hazard, by providing a perverse incentive for investors to be less diligent and less vigilant.

The very nature of corporate governance ensures that government regulation of it will be counterproductive, insofar as regulation prevents shareholders from organising their own corporations in their own ways. Even reforms whose proposals might well be sensible for many companies should be opposed when presented as prescriptions for all: not everything that is desirable can or should be compulsory.

'Long-termism' and the Unitary Board

Sadly, even while correctly criticising the 'box-ticking' approach to corporate governance, Djanogly seems to share the popular misconception that 'long-termism' and the unitary board are valuable in and of themselves. Both, however, can be damaging. As the German and especially the Japanese economies amply illustrate, 'long-termism' is often associated with pervasive misallocation of resources and sustained failures. And Enron and Marconi demonstrate that the presence of a unitary board is no guaranty that shareholder interests will be protected.

Djanogly is right to prefer the Anglo-American unitary board to a German-style two-tier board. The reason why the former is preferable, however, is not because the German board has two tiers, and restricts the monitoring role to non-executives. Rather, it is because German law requires that between 33% and 50% of the supervisory board members must be employee representatives, and that the employee directors have a veto over the appointment of non-employee directors. Like all attempts to implement the pernicious stakeholder doctrine[iii], this restriction prevents shareholders from devoting their property to ends of their own choosing. The price of such limitations is very high indeed: what is at stake is nothing less than private property and the relationship of agent and principal.

What is crucial for good corporate governance is not long-termism or the unitary board or any specific mechanism, but ensuring that shareholders have the right to protect their own interests. However valuable a mechanism the unitary board may normally be, what actually needs protection from the government, from the TUC, from the corporate social responsibility and stakeholder movements, and from UK regulators is the fundamental right of shareholders to control the corporations that ultimately belong to them.

Ends and Means

Djanogly is strictly correct to say that

> effective corporate governance, as we understand it, does not necessarily lead to more efficiently led companies or indeed a culture of long term creation of shareholder value.

But that is partly because no human institution can ever be guaranteed to produce the desired results, and because all tools, including corporate governance mechanisms, need to be used properly. Even when they are, however, ends must be differentiated from means. Corporate governance will not necessarily promote the creation of long-term owner value, because not all corporations are intended to pursue that end: maximising long-term owner value is the definitive objective of business as an activity[iv], not of the corporation as an organisational form. Corporations can have whatever objectives their shareholders wish, subject only to what the law allows.

Even ostensibly commercial corporations often do not seek to maximise shareholder value. In Japan, for example, generating returns for shareholders is less important than increasing market share or maintaining employment; the primary function of shareholdings is to assure markets and supplies, not to reward capital. Similarly, German commercial companies are typically more concerned to increase size and power than to generate shareholder returns. Reflecting such different objectives, corporate governance mechanisms resembling those used in the Anglo-American system produce predictably different effects when employed in Germany and Japan.

The Way Forward

Contrary to what Djanogly suggests, the way to protect shareholder interests is not through another official review. Even less should reliance be put on the Company Law Review: it is seeking to reintroduce the pernicious stakeholder doctrine through the Operating and Financial Review.

The best way to bring about beneficial changes is instead to encourage maximum experimentation in the marketplace, and to allow forms of corporate governance to compete for investor support. All reforms should be directed at protecting the rights of the shareholders themselves to determine the degrees and kinds of accountability they want to have.

The value of doing so is clear. According to a recent analysis of 1,500 stocks by the (US) National Bureau of Economic Research, companies with the most restricted shareholder rights had annual earnings and valuations between 1990 and 1999 that were almost 9% lower than companies with the fewest restrictions.[v] Shareholder freedom is associated with both good corporate governance and superior corporate performance.

Notes and References

1. For a full explanation and justification of this concept of corporate governance, see Elaine Sternberg, *Corporate Governance: Accountability in the Marketplace* (Institute of Economic Affairs, 1998; new edition forthcoming). The corporate objective referred to is typically that which is set out in the corporation's Memorandum of Association or comparable constitutional document.

1. In the UK, conspiracy to defraud.

1. For an analysis of what the stakeholder doctrine is, and why it is so dangerous, see Elaine

Sternberg, *The Stakeholder Concept: A Mistaken Doctrine*, The Foundation for Business Responsibilities, 1999; available online from the Social Sciences Research Network on http://ssrn.com.

[1.] For a full explanation, derivation and justification of this concept of business, see Elaine Sternberg, *Just Business: Business Ethics in Action*, second edition, Oxford University Press, 2000, especially Chapter 2.

[1.] Gompers, Paul, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No. 8449, August 2001.

Commentary on 'Developments in Corporate Governance', Jonathan Djanogly

by

Terry Arthur FIA

Mr Djanogly provides a courageous and helpful reminder to those on the corporate governance juggernaut, which is increasingly seen by business as "some kind of monster growing out of control".

Several suggestions seem right on the button. The law of unintended consequences is clearly at work; after a decade and a half of reviews the subject is less well defined than before, executive pay has mushroomed alongside Remuneration Committees, and so on. Ramping boards with independent non-executives as suggested by Higgs will not improve strategy. Indeed Higgs is a major threat to the unitary board, alongside trade unions and the Corporate Social Responsibility lobbies.

Mr Djanogly is also well aware of the issue of shareholder rights. He suggests that the Government has concentrated on directors and auditors and underplayed the role of shareholders, and he is concerned that the shareholder playing field is biased against individual shareholders, whose ownership is now only a quarter or so of that of institutions.

All this promises much, but ultimately Mr Djanogly disappoints, mainly because of the lack of philosophy. This is especially sad given that the gets so near – "we…need to stand back and consider what we actually see as the end result". But this promising approach flatters to deceive because Mr Djanogly then suggests that "the best that will ever be achieved is a consensus that is generally acceptable to the various interested parties" – which for him, perhaps because he is a politician, includes those professing an aim to improve so-called environmental and social justice. He has failed to stand back far enough to ask the questions "who are *we*?" and "which parties have *valid* interests?"

This sends Mr Djanogly off the rails. Perhaps because of his apparent view that any UK citizen is a valid interested party in UK corporate governance he attributes the "driving force" of the corporate governance racket as – guess what – "globalisation" of companies and capital. Thus "Government is at pains to show that it is being proactive" against a background of British companies being "carried along on an international wave". This is a very dodgy premise when the share of international trade in world output appears to have only just scraped back to pre-1914 levels.

In fact, what has become more international is the activities of pressure groups such as Greenpeace and Friends of the Earth.

Again it is frustrating to read Mr Djanogly on CORE (the Corporate Responsibility coalition, representing some 25 organisations) only as a possible threat to the unitary board concept.

(Nowhere does he justify this concept in the first place.) Many of these organisations are entirely unaccountable to other parties and very badly governed; indeed their international organisation is often designed with this in mind.

Surely it is absurd to believe that such organisations have any right to influence the governance of other entities which happen to be organised as PLCs or the equivalent. Yet Mr Djanogly seems to accept their influence without breaking his stride, bewailing the fact that little of this “cultural change” has yet filtered down to smaller companies.

Instead Mr Djanogly reserves his cynicism for fund managers, wondering whether their keenness to adopt Higgs quickly was founded upon the idea that their own corporate governance may not always bear much scrutiny. This is undoubtedly true in some cases – but why the bias? Is it because he does not want to fall out with the critics of corporate Britain? We could be forgiven for thinking so, because he accuses the British authorities of failing to investigate institutions “in the way they are being carried out in the United States” – despite his chastisement of the British Government’s constant references to Enron, because “Britain has not seen Enron sized instances of fraud since the inception of the Combine Code”.

If only Mr Djanogly could go that extra mile. He recognises that corporate governance has got worse but cannot bring himself to accept the reason, which is that it has been adopted by interfering busybodies who have no legitimate interest – other than being “interested parties”. If the simple rights of shareholders – resting on freedom of association and contract – were restored, then shareholders could get on with governing their companies, and the subject could be put to bed.

[i.] For a full explanation and justification of this concept of corporate governance, see Elaine Sternberg, *Corporate Governance: Accountability in the Marketplace* (Institute of Economic Affairs, 1998; new edition forthcoming). The corporate objective referred to is typically that which is set out in the corporation's Memorandum of Association or comparable constitutional document.

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[iv.] For a full explanation, derivation and justification of this concept of business, see Elaine Sternberg, *Just Business: Business Ethics in Action*, second edition, Oxford University Press, 2000, especially Chapter 2.

[v.] Gompers, Paul, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No. 8449, August 2001.